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IN THE

Supreme Court of the United States

OCTOBER TERM, 1953

No. 723

CHARLES T. FISHER,
Petitioner,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT AND BRIEF IN SUPPORT THEREOF

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This petitioner, by his attorney, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Sixth Circuit entered in this case on February 3, 1954, affirming the decision of The Tax Court of the United States.

OPINIONS BELOW

The opinion of The Tax Court (R. 89a-93a) is reported in 19 T. C. 384. The opinion of the Circuit Court of Appeals (R. 99a-104a) is reported in 209 F. (2d) 513.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 3, 1954 (R. 99a). The jurisdiction of this Court is invoked under Section 1254 of the Federal Judicial Code, Title 28, United States Code, Sec. 1254.

QUESTIONS PRESENTED

1. Whether the gain on the sale of notes in default as to principal and interest payments for a "flat" price (without any allocation as to principal and interest) to a third party in a valid and bona fide transaction is taxable as capital gain or as ordinary income.

2. If it were to be held that when petitioner sold his defaulted notes under the circumstances above stated, he received ordinary income taxable as such, should such ordinary income be limited to the amount which the debtor paid on account of the defaulted interest to the purchaser in the year 1944, the year here involved.

STATUTES INVOLVED

The statutes involved are set out in the Appendix, *infra*, pp. 17-19.

STATEMENT

As the Circuit Court of Appeals stated in its opinion, "There is no factual controversy, the case having been submitted upon the stipulation of facts supplemented by uncontroverted evidence accepted by The Tax Court in its findings."

Insofar as material for the purpose of this petition, the facts are: Petitioner filed his income tax returns on a calendar year cash basis. Petitioner had held for many years a series of 72 two-year six per cent notes issued by a Florida real estate development corporation at intervals beginning in July, 1929, aggregating $133,849.44 in principal amount. Unpaid defaulted interest had accrued to August 31, 1944, in the amount of $75,574.29. The total of principal and interest to August 31, 1944 amounted to $209,423.73 (R. 24a-25a, 27a-28a). All but $2,049.99 face amount of these notes were in default as to principal and interest, and no principal or interest had been paid on any of said notes (R. 26a, 45a-46a). Petitioner, by letter dated August 25, 1944, offered to sell to Prime Securities Corporation, a Michigan corporation, organized in 1931, for a "flat" price of $200,000.00 "all of his right, title and interest in" the said notes of the Florida corporation, to be paid by application of his total indebtedness to Prime of $167,465.00, and the balance in cash (R. 44a-45a). This offer was accepted and payment was made by Prime in accordance therewith on September 1, 1944 (R. 43a). The total of the principal and interest owing on these notes was paid to Prime in the years beginning in 1944 and ending in 1950 (R. 28a-29a). In 1944, the year here involved, there was paid to Prime on these notes $8,849.22 of principal and $10,994.25 in accrued interest.

In his income tax return for 1944 petitioner reported a long term gain of $66,150.56, fifty per cent taxable (R. 28a).

He paid an income tax of $76,175.25 for the year 1944 (R. 15a).

Respondent determined that petitioner's total gain of $66,150.56 should be taxed as ordinary income for 1944. In the "Explanation of Adjustments" set out in the 90-day letter proposing the assessment of the deficiency, it was stated (R. 12a):

> "It is held that you *realized a gain* of $66,150.56 on the disposition of certain Miami Beach Heights notes held by you, having a face value of $133,849.44, upon which notes interest of $75,574.29 stood accrued, for a selling price of $200,000.00, *no part of which, under the sales agreement, was to be applied in payment for accrued interest,* and that said gain is taxable as ordinary income under the provisions of Section 22(a) of the Internal Revenue Code." (Emphasis added.)

The Tax Court held petitioner was in receipt of "interest" of $66,150.56 in 1944, taxable as ordinary income (R. 91a). The Circuit Court of Appeals affirmed (R. 99a). The Tax Court in its findings of fact, after referring to the acquisition of the notes by the petitioner and the sale of same by him to Prime, found that, "The above transactions were all bona fide." The Circuit Court of Appeals in its opinion said, "There is no question here of the bona fides of the sale of the notes to Prime. The Tax Court found that all of the transactions referred to in its findings were bona fide, and the Commissioner does not challenge this finding."

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that when petitioner sold his notes, which were in default both as to principal and interest, for a flat price (with no allocation as to principal and interest) to a third party in a bona fide transaction, that he received ordinary income, taxable as such to the extent of the defaulted interest.

2. In holding that petitioner received $66,150.56 of defaulted interest in 1944 when he sold his notes to Prime.

3. In holding that the principle stated in *Helvering v. Horst*, 311 U. S. 112; *Hort v. Commissioner*, 313 U. S. 28; *Rhodes' Estate v. Commissioner*, 131 F. (2d) 50; and *Harrison v. Schaffner*, 312 U. S. 579, 582, are applicable to the decision of the question involved in this case.

4. In holding that when petitioner sold his notes, which were in default both as to principal and interest, to a third party in a bona fide transaction, that to the extent of the defaulted interest, he received income for the use of money taxable as ordinary income.

5. In the alternative, the Circuit Court erred in holding that when petitioner sold his defaulted notes, he received ordinary income, taxable as such, to the extent of the total amount of the defaulted interest, instead of holding that he was so taxable only on the amount of the defaulted interest paid by the debtor to Prime in the year 1944 in the amount of $10,994.25.

6. In failing to hold that petitioner had correctly reported the gain on the sale of his notes as capital gain, and had paid the income tax due thereon.

7. In affirming the decision of the Tax Court.

REASONS FOR GRANTING THE WRIT

1. The Circuit Court of Appeals has rendered a decision in conflict with the decision of the Second Circuit Court of Appeals in *Carman v. Commissioner*, 189 F. (2d) 363 (1951).

2. The Circuit Court of Appeals has decided a federal question in a way probably in conflict with the applicable principles set out in the decision of this Court in *Maass v. Higgins*, 312 U. S. 443 (1941).

3. The Circuit Court of Appeals has decided an important question in the administration of the Revenue Laws, which has not been, but should be, settled by this Court. The transaction involved is a common and frequently recurring one in the commercial and investment fields.

BRIEF IN SUPPORT OF PETITION

Reference to the opinions below, jurisdiction, a statement of the questions presented, facts in this case, specification of errors to be urged, and reasons for granting the writ are found in the foregoing petition. The statutes involved are set out in the Appendix, *infra*, pp. 17-19.

ARGUMENT

This case involves a valid and bona fide sale by petitioner of 72 two-year, six per cent corporate notes, which he had acquired at a cost equal to face value from time to time, beginning in July, 1929. On August 31, 1944, the total face or principal value of such notes amounted to $133,849.44, and the defaulted interest amounted to $75,574.29. Substantially all of the principal of said notes and all of the said accrued interest thereon had been and were in default from the date of issuance. On September 1, 1944, petitioner sold these notes in a bona fide transaction to a corporate third party for a "flat" price of $200,000.00, without allocation as between principal and interest. Thereafter, the debtor paid off the said principal and interest to the purchaser in the years 1944-1950. In 1944 the amount of these payments was $8,949.44 of principal and $10,944.25 in interest. Petitioner reported the difference between his cost or face value of the notes as capital gain in 1944 and paid income tax for that year in the amount of $76,175.25. The respondent determined a deficiency of $52,496.94 (R. 11a), which almost entirely is attributable to the inclusion of the gain of $66,150.56 on sale of the notes as ordinary income.

There is no question of tax avoidance in this case. For all that appears, petitioner may have paid more income tax by reason of reporting the gain as capital gain in 1944 than he would have paid had he not sold the notes and had received the principal and interest payments in the years as paid by the debtor, 1944 to 1950. The Tax Court held, and the Circuit Court affirmed, that the difference between the cost of the notes and the sales price was taxable to petitioner in 1944 as ordinary income.

At the outset it is clear, and it is not questioned, that the notes involved in this case were capital assets. Section 117(a)(1) of the Internal Revenue Code, 26 U. S. C. Sec. 117; *Graham Mill & Elevator Co. v. Thomas*, 152 F. (2d) 564 [C. C. A. 5, 1945].

We respectfully submit that this case is directly in conflict with the decision of the Second Circuit Court of Appeals in *Carman v. Commissioner*, 189 F. (2d) 363 (1951), cited in our brief in the Circuit Court of Appeals. There the taxpayer in a corporate reorganization had received a specified amount of common stock on account of defaulted interest on old bonds of the reorganized corporation, which had accrued during his period of ownership, and prior thereto. (See for full facts, *Carman*, 13 T. C. 1029.) The Commissioner sought to tax the value of this common stock as interest income, contending that the element of interest was not a "security" exchanged for stock pursuant to a plan of reorganization, but was a payment of accrued interest taxable as ordinary income. The Second Circuit Court of Appeals held for the taxpayer, saying (189 F. (2d) at p. 364):

> " * * *. The argument is that the claim for accrued interest was severable from the claim for the principal of the old bonds and is not a 'security' exchanged for stock pursuant to a plan of reor-

> ganization. *The contention is ingenious but unsound. The bondholder* had a single claim for principal and interest; * * * ." (Emphasis added.)

The Court then went on to apply the principle applicable to purchasers of bonds and notes to a case involving the original owners, and said at page 365:

> "* * *.We think that the rule as to the purchase and sale of bonds with interest in default tends to support our conclusion. *When bonds in default are bought 'flat,' the price paid is not apportioned between principal and interest,* and when they are sold the consideration received is set off against the purchase price to determine whether the investment resulted in gain or loss, *no part of the sale price is regarded as taxable interest.* The consideration received on an exchange of the bonds for stock or securities would be similarly treated, had not §112 (b)(3) postponed recognition of the gain or loss. We agree with The Tax Court's disposition of the issue as to the common stock [13 T. C. 1029] and see no occasion to add to it further. * * *." (Emphasis added.)

In a footnote the Court cited: *Clyde C. Pierce Corp. v. Commissioner,* 120 F. (2d) 206 (5th Cir.); *Lloyd v. Commissioner,* 154 F. (2d) 643 (3rd Cir.); *Hewitt v. Commissioner,* 30 B. T. A. 962; *R. O. Holton & Co., Inc.,* 44 B. T. A. 202; and *Noll v. Commissioner,* 43 B. T. A. 496. These footnote citations were cited in the petitioner's brief, filed with the Circuit Court of Appeals, and we rely on them in this proceeding. See also *Shanis,* 19 T. C. 641, cited in our brief.

We believe that the decision of the Circuit Court of Appeals is in direct conflict with the foregoing decision of the Second Circuit Court of Appeals in the *Carman* case. Seemingly the Circuit Court has overlooked the *Carman* and

Shanis cases when, in its opinion, the Court said that "no exact precedents have been cited and none are found."

A closely analogous case on principle to the *Carman* case is *Swiren v. Commissioner*, 183 F. (2d) 656 [C. C. A. 7, 1950], [cert. den. 340 U. S. 912], where it was held that the sale of a partnership interest, including billed but uncollected items for services, where both the partnership and the selling partner are on a cash basis, is a capital transaction resulting in capital gain or loss. After several reverses in other cases, the Commissioner accepted the holding in this case in G. C. M. 26379, 1950-1 C. B. 58, revoking a prior ruling to the contrary.

In *Willcuts v. Bunn*, 282 U. S. 216, 51 Sup. Ct. 125 (1931), taxpayer sold municipal bonds at a profit and tried to escape the income tax thereon, contending that "income from municipal bonds was tax exempt." This Court held that the exemption applied only to interest on the municipal bonds and not to gain on the sale thereof. This Court said that "the profits on such sales are in a different category of income from that of the interest payable on the bonds."

In *United States v. Stewart*, 311 U. S. 60, 61 Sup Ct. 102 (1940), this Court said: "Analytically, income derived from mere ownership of the bonds is different from income derived from dealings or transactions in the bonds."

We respectfully submit that the decision of the Circuit Court in this case is probably in conflict with the principles of the decision in *Maass v. Higgins*, 312 U. S. 443, (1941). This case involved the question of valuation of securities for estate tax purposes where the executor elected to evaluate the estate as of a year after the date of death. The Government tried to include the value of interest and dividends received during the year on the theory that the elements of principal and interest were separable and the interest should therefore be added as a separate item of

value. The Supreme Court disagreed. In the course of its opinion this Court said:

> "It is true that a bond embodies two promises, one to pay the principal at maturity, the other to pay interest at intervals until maturity. And the promise to pay interest or rent, or the expectancy of dividends upon stock, the amount of such payments, the past and prospective regularity of the payments, and other elements bearing upon the expectation of the receipt of income affect the value of any income producing property. *But these elements are not separately valued in appraising the worth of the asset at any given time. It is the uniform practice to value the asset as an entirety, taking into consideration all the elements that go to give it value in the market.*" (Emphasis added.)

This Court further stated, in language peculiarly applicable to the position of petitioner herein (312 U. S. at page 449):

> "As has been said, the view we take comports with standard business practice; *whereas the theory advocated by the Government involves the attribution to interest payments of a quality derived from a refined separation of so-called rights inherent in the ownership of income producing property.* Conceding that the ownership of a bond involves both the right to receive principal and the right to receive income, it is a highly artificial concept that an interest payment is a disposition, *pro tanto*, of the latter right by the owner of the obligation." (Emphasis added.)

The Circuit Court in its decision in this instant case said:

> "We have noted in *Maass v. Higgins*, 312 U. S. 443, the generalizations which taken from their context would cast doubt upon the rule here applied but the *Maass* case involved the question of valuation of securities for estate tax purposes where

> the executor elected to evaluate the estate as of a year after the date of death. They must be construed in the light of the problem then before the court. * * *"

We respectfully dissent from this appraisal of the *Maass* case and its applicability to the question presented in this case, and submit that the principles stated in the *Maass* case strongly support the petitioner in this case. Nor is the *Maass* case to be explained away by the statement of Randolph E. Paul, in Federal Estate and Gift Taxation, Volume 2, page 1339, quoted by the Circuit Court of Appeals in its decision "that the Court was evidently impressed with the taxpayer's charge of double taxation." That statement had reference to the effort of this Court to determine the intention of Congress in enacting the statuory provision there involved, and does not detract from the force of the principles there stated as applied to the questions presented in this case.

We now come to consideration of the decisions relied on by the Circuit Court of Appeals in support of its decision. In *Helvering v. Horst*, 311 U. S. 112, this Court held that where interest coupons are detached from bonds shortly before their due date, and delivered to another as a gift, the donee collecting the interest at maturity and within the taxable year, the donor on a cash basis is taxable on the amount of such interest. This Court stated the question in that case to be: "The sole question for decision is whether the gift during the donor's taxable year of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor." This Court then said: "When, by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of interest to his donee, he has enjoyed the eco-

nomic benefits of income in the same manner and to the same extent as though the transfer were of earnings. * * *"

Contrary to the facts in the *Horst* case, however, the taxpayer here did not separate his right to interest payments from his investment, since there was no allocation either by the petitioner or by the purchaser as between principal and interest. Moreover, the payment in question was not made by the debtor but by a third party in a bona fide transaction. That the holding in the *Horst* case cannot be applied to the facts in the case here presented is emphasized by this Court in *Harrison v. Schaffner*, 312 U. S. 579, decided on the same day as the *Horst* case, March 31, 1941. In the *Schaffner* case, the life beneficiary of a testamentary trust assigned to certain of her children specified amounts in dollars from the income of the trust for the year following the assignment. The question for decision was whether this assigned income which was paid by the trustee to the several assignees was taxable as such to the assignor or to the assignees. This Court held this income taxable as such to the assignor and in its opinion said:

> "Nor are we troubled by the logical difficulties of drawing the line between a gift of an equitable interest in property for life effected by a gift for life of a share of the income of the trust and the gift of the income or a part of it for the period of a year as in this case. 'Drawing the line' is a recurrent difficulty in those fields of the law where differences in degree produce ultimate differences in kind. See *Irwin v. Gavit*, 268 U. S. 161, 168 [1 U. S. T. C. Par. 132]. It is enough that we find in the present case that the taxpayer, in point of substance, has parted with no substantial interest in property other than the specified payments of income, which like other gifts of income, are taxable to the donor. Unless in the meantime the difficulty be resolved by statute or treasury regulation, we leave it to future judicial decisions to determine precisely where the line

> shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner, for all substantial and practical purposes. Cf. *Helvering v. Clifford, supra.*"

In *Farkas v. Commissioner*, 170 F. (2d) 201, [C. C. A. 5, 1948], the taxpayer's father set up a testamentary trust, under the terms of which the income was to be paid to testator's eight children for life. The will provided that the trust was to continue during the life of the eight children and until testator's youngest grandchild attained the age of twenty-one years, at which time the trust was to terminate and the estate was to be divided among the direct decedents of the testator *per stirpes*. After the death of his father, taxpayer executed a trust instrument which declared, "I hereby transfer and convey all my right title and interest to the profits, dividends or income from the Estate of Sam Farkas (father) * * * to my brother, Mack Farkas, in trust, this trust to terminate within ten years from the date hereof or upon the death of Mack Farkas." The Commissioner determined that taxpayer was taxable on the entire one-eighth share of the income from his father's testamentary trust, and relied on *Harrison v. Schaffner, supra*, and *Helvering v. Horst, supra*. The Tax Court sustained the Commissioner, but the Fifth Circuit Court of Appeals reversed. After analyzing the decisions of this Court in those cases, Chief Justice Hutcheson, in a concurring opinion quoted from the opinion of this Court in the *Schaffner* case, in which this Court said:

> "* * *. *Unless in the meantime the difficulty be resolved by statute or treasury regulation, we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner for all substantial and practical purposes.* (Italics supplied.)"

The Chief Justice also called attention to the fact that Treasury Regulation 111 Sec. 29.22, as added by T. D. 5488, 1946-1 C. B. 19, and T. D. 5567, 1947-2 C. B. 9, furnished conclusive support to the "judicial determination" that the Fifth Circuit Court made that the income from the assigned trust interest was not taxable. This Treasury Regulation fixed the time within which, though assigned, trust income is taxable to the grantor as substantial owner thereof at within ten years commencing with the date of the transfer, and was made applicable to years after the year involved in that case. It is now further significant that Congress in H. R. 8300, Revenue Code of 1954, now pending in Congress, proposes to enact the provision of said Treasury Regulation into law by Sec. 673(a) of said House Bill, providing that "the grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may be reasonably expected to take effect in possession or enjoyment within ten years commencing with the date of transfer of that portion of the trust."

In its opinion, the Circuit Court of Appeals in this case also refers to *Hort v. Commissioner*, 313 U. S. 28, where this Court held that the amount received as consideration for cancellation of a lease to realty was essentially a prepayment of rent, clearly an income item. We submit that this decision is not applicable because here there was no prepayment of interest by the purchaser who was not the debtor, and there was no allocation of the purchase price as between principal and interest, and the transaction was entirely bona fide.

Rhodes' Estate v. Commissioner, 131 F. (2d) 50, cited by the Circuit Court of Appeals involved the sale of an isolated separated income item, a dividend declared, which the tax-

payer in that case was entitled to receive, and can have no application to the facts involved in this case.

In *Chamberlain v. Commissioner*, 207 F. (2d) 462, (C. C. A. 6), [cert. den. March 8, 1954, 98 L. Ed. Advance p. 392], the Court, in answer to Commissioner's contention that the payment by the purchaser for preferred stock was in reality a payment of a dividend by the corporation to the taxpayer seller, said: "The money he received was received from the insurance companies. It was not a 'distribution' by the corporation declaring the dividend as required by the statute." So, in this case, the money taxpayer received was not from the debtor for the use of money loaned, but from the purchaser of the notes, and there is no question as to the bona fides of the transaction.

ALTERNATIVE CONTENTION

If it were to be held that the case here is governed by the *Horst* case, and as applied to a gift of a defaulted note, by *Austin v. Commissioner*, 161 F. (2d) 666, then we respectfully submit that petitioner should be held taxable only on the amount of interest paid by the debtor to the purchaser in the year here involved, or $10,994.25. See also *Annie A. Colby*, 45 B. T. A. 536. In that case there was a gift of defaulted notes in 1935. The trustee collected the back interest in 1936 and 1937. The Tax Court held that the donor had realized no income in 1935 since none of the interest was paid in the year of gift.

Wherefore, it is respectfully submitted that this petition for a writ of certiorari to review the judgment of the Circuit Court of Appeals should be granted.

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APPENDIX

STATUTES INVOLVED

Internal Revenue Code, 26 U. S. C. Secs. 117, 22.

Sec. 117(a)(1)—as amended by §151(a) of the 1942 Revenue Act:

(a) *Definitions*—As used in this Chapter—

(1) Capital assets.—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(1), or an obligation of the United States or any of its possessions, or of a State or Territory, or any political subdivisions thereof, or of the District of Columbia, issued on or after March 1, 1941, on a discount basis and payable without interest at a fixed maturity date not exceeding one year from the date of issue, or real property used in the trade or business of the taxpayer.

Sec. 117(a)(4)—as amended by §150(a)(1) of 1942 Revenue Act:

(4) *Long-term capital gain.*—The term "long term capital gain" means gain from the sale or exchange

of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing net income.

Sec. 117(b)—as amended by §150(c) of 1942 Revenue Act:

(b) *Percentage taken into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than 6 months.

Sec. 117(c)(2)—as amended by §150(c) of the 1942 Revenue Act:

(c) *Alternative Taxes.*—

(1) *Corporations.*— * * *

(2) *Other taxpayers.*—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12, a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 50 per centum of such excess.

Sec. 22(a):

General Definition.—"Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *.